Easing trade costs within Mercosul

Reiss, Daniel G

23 October 2012

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Daniel Gersten Reiss†

October 23, 2012

Abstract

The paper describes the joint policy of Brazil and Argentina regarding the currency use in bilateral trade. The Local Currency Payment System (SML) framework is investigated as an instrument of reducing trade costs by providing new financial integration mechanisms and its implications according to usual trade issues debate. We cut across different issues related to the SML rationale. Additionally, we describe and analyze the data available for the system showing that the SML use is more common to Brazilian exports than to Argentine ones.

Keywords: international trade; Mercosul; cost reduction; payment system

1 Introduction

The scope of trade-related issues has been enlarged since countries began to consistently negotiate tariff reductions on the second half of the twentieth century. Along with this fact, regional agreements have gained more prominence in so far as trade negotiations became more complex. In this unsettled world, novel solutions have to be pursued to address the new faced challenges. When we look into relations between trade agents, the ones who actually operate trade, complexity is not arguably smoother than it is in relations among countries. Dealing with the harmonized system to classify your own traded goods - even if, theoretically, it could seem to be simpler, as suggests a standardized system - it requires a large amount of time to correctly define the appropriated duty to be applied; additionally, it may sometimes not be even possible at all. Customs obligations are certainly a significant non tariff barrier to trade.

Barriers to trade may also be identified when we think about foreign exchange. In addition to all difficulties that a trader may find in shipping and in customs clearing her goods, a financial transaction is still required to settle the whole commercial operation. The importer has to pay for the product she has purchased. However, her local currency is not often the same as the exporter's.

*I especially thank Mauricio Barata de Paula Pinto for remarkable contribution in refining this paper and Ali Arbia for many helpful comments.

†Email: daniel.gersten@bcb.gov.br

So, a foreign exchange transaction is also necessary. In addition to that, if both currencies are not internationally fully convertible, a third currency may also be necessary to settle the trade operation and is used as an invoice currency. In this case, another additional exchange transaction will be required if the exporter's local currency is expect to be held in the end. As the complexity of financial transactions increases, so its related costs. Thus, it is arguable that these exchange costs associated to a trade operation are also a financial barrier to trade. So, contributing on reducing these financial costs also allows trade to flourish.

The Brazilian and the Argentinean governments aimed these trade costs when launched the Local Currency Payment System (SML, on the Portuguese acronym for *Sistema de Pagamentos em Moeda Local*) on October, 2008. The system had been under development since 2005 under the Mercosul framework and was launched during the deepening of the 2007 international financial crisis. Carried by the central banks of both countries, the SML has established a simplified foreign exchange rationale for the settlement of trade operations between these two major partners, which have an annual turnover of trade of approximately USD 30 billion. The SML payment system is connected to an endogenous exchange system, which allows exporter and importers to use their own local currency without having to buy or sell an international convertible currency. This means that a Brazilian exporter can use the SML to settle a trade operation that has been invoiced in *reais* (BRL) by receiving in her own currency, while the importer will be able to pay for the total settled amount in *pesos* (ARS). The exchange between *reais* and *pesos* will be carried by the SML, or in other words, by both central banks. Mutatis mutandis, the same can happen for the settlement of an Argentine export.

The aim of this paper is to present the SML framework as a joint policy held by Brazil and Argentina regarding the currency use in bilateral trade and to discuss its major implications from an international trade viewpoint. It will focus on suggesting discussion topics on different aspects of the system. Additionally, a four-year set of data will be presented. In the following section we analyze the SML framework by describing its legal grounds and its operational functioning. On section 3, the usage of SML and the relation between the SML rationale and the usual trade policy perceived from both SML countries are taken into account. Section 4 presents the currently available data and shows some characteristics that can already be noticed and section 5 concludes.

2 Background

Mercosul's Council of the Common Market Decision No. 25/2007 [11] provides for the establishment of a payment system which would allow the use of local currencies on trade operations among the States Parties. Such mechanism should be established bilaterally between central banks by agreements. The first experience to be carried out[1] was made by Brazil and Argentina, which

[1] and sole by October, 2012.

operation started in October, 2008.

Agreements for the settlement of trade operations among countries are not new in Latin America. The Latin American Integration Association (Aladi) has been running the Agreement on Reciprocal Payments and Credit (CCR) since the early 1980's. It is a twelve-country agreement which focus on providing forex liquidity to regional trade and on reducing credit risk by transferring it to the sovereign states. According to the CCR settlement system, countries settle their trade positions every four months on a multilateral net position basis. This multilateral settlement is carried in dollars and the net settlement is especially advantageous on requiring less availability of foreign currency. The reduced amount of international reserves available in those countries during the 80's made the CCR particularly useful in those days. In a period when the likeliness for sovereign defaulting was not low for these countries, the CCR allowed trade among them [12]. Currently, the CCR is less used than it used to be [1], however it continues to be a typical example of a Latin America's trade arrangement.

There are still some other examples rather than the CCR as numerous regional arrangements have proposed different solutions, improving Bhagwati's spaghetti bowl of regional agreements[4]. A finite number of countries with an increasing large number of arrangement among them - eventually on the same issue - suggests the existence of some difficulties on addressing systematically and straightforwardly the problems that are faced by them. Examples of autarkic decisions with major implications in neighbors are not rare. Indeed, Baumann and Mussi [3] state that the SML is a noteworthy exception to the lower ability of Latin America countries on coordinating their economic policy decisions, something that would be a condition to produce some stability between national currencies of the region. Saraiva [13] reinforces the idea that regional economic progresses have been even harder to be obtained when negotiated exclusively inside Mercosul and between Brazil and Argentina. The SML implementation certainly is an exception to this perception. The system is not only a bilateral financial policy but a combined process that is jointly operated by the central banks and that integrates the national payment systems.

When launched, the bilateral payment system was promoted by mentioning four major aims[7]: (1) to increase the access of small and medium-sized agents; (2) to allow foreign trade in local currency; (3) to reduce the cost of transactions and (4) to strengthen the Brazilian real/Argentinean peso market. Objectives (1) to (3) are directly related to trade, while objective (4) is a condition that facilitates trade by reducing transactions costs as no other currency is needed to settle the trade operation. Providing access to small and medium-sized agents means an attempt to reduce barriers to these agents and to provide them with the possibility of benefiting from a larger international market. As the size of an agent is smaller, more barriers seems to exist on accessing the international market: lower access to information (or a higher cost to access it) and to trade-related products (as hedging). By allowing foreign trade in local currency, local producers could benefit from an easier way to export, without having to conduct forex transactions, and also from the removal of currency risk on their local currency. The SML provides a simplified framework for sending money across the border relatively to the standard forex operations, what allows financial institutions to reduce their costs and, thus, their rates to consumers. Additionally, the promotion of real-peso market could make possible agents to choose between using or not a third currency on their trade operations, reducing costs and promoting trade. All these issues seems to be matters of trade intrinsically related to agents or, as we could say ultimately, relater to individuals. It is a micro-perspective from the international trade conundrum, which often remains quasi-exclusively linked to state relationship and its barriers. Measuring the achievements on this micro-perspective appears to be an interesting task. However, this analysis is beyond the scope of this paper and remains as a suggestion of further studies.

Focusing on the trade relationship between Argentina and Brazil, it represents a turnover over USD 30 billion per year, what is substantially significant when the trade among Latin America countries is considered. To Brazil, Argentina is the destination of over 10% of its exports and 9% of its imports[5], while Brazil accounts for 20% of Argentina exports and one third of its imports[6]. Albeit both neighbor countries having a close trade relationship, most of its trade is invoiced and settled in US dollars. This means additional costs due to an extra exchange transaction when the traded goods are priced in one of the local currencies.

SML's design focused on simplifying payment operations on a forex viewpoint. This is what distinguishes SML from other regional trade agreements. The proposed mechanism in Mercosul was to avoid extra costs on trade due to the lack of currency convertibility by launching a settlement system which made available a financial service aiming to tackle this market weakness.

2.1 The trade operating cycle and the financial function

We can point four steps that are crucial for the operation of a trade business: the purchase of a good, the cash outflow on payment for the purchased good, the sale of the good and the cash inflow due to the sold good. The first one represents the moment when the trader agrees to buy a specific good. For an industry, it might represent the aggregated amount of inputs that are bought in order to make production possible. The second represents the moment when the trader pays for the goods (or inputs) that were bought. The third period represents when the trader agrees to sell the good or, for an industry, the moment it sells its production. The fourth is the one when the buyer pays the trader. We shall be aware that those periods not mandatorily happened in that order. In fact, the order that the periods happen is an object of study of business administration and utterly is what allows a business to be viable. For the purposes of our analysis, it is sufficient to distinguish the first and third periods from the second and fourth, as the formers are related to business negotiation and agreements and the latters are related to the financial settlement.

The same moments occur for the international trade. In fact, we will consider the trader - or the industry - as the exporter and the buyer as the importer[2]. Both sets of periods (first and third, and second and fourth) also occur and their order may still be defined for each business negotiation. The original seller (or the input provider) is considered on the exporter's production chain. Thus, an international trader will aim to maximize her profits from optimizing revenues from the operating cycle. We shall be aware that as international purchases and sales are being held different currencies are being used to settle them. There is no restriction on buying and selling in different currencies and the lack of this constraint will be relevant to our further considerations.

The SML is an international payment system that may be used to settle the third moment, when the importer pays the exporter for the traded goods. When both of these agents use the same currency no foreign exchange is necessary. One example is when a product is traded between countries that use the same currency: when a good is traded between eurozone countries, both importer and exporter use the euro. Albeit the eurozone countries carry a substantial percentage of international trade, most of it happens between countries that uses different currencies. In this case, the exporter and the importer will agree in which currency they will invoice and settle their trade operation[3]. As a common example, one trading with the United States is likely to choose the dollar, as this is the most used currency in international trade[4]. However, when the exporter's and the importer's local currencies[5] are not internationally convertible, a third currency is often chosen to make the financial transaction viable. So the importer buys this third currency in order to pay the exporter for the traded goods. The exporter, in order to have her local currency, then sells this third currency, buying her own currency[6]. The SML acts exactly in that point, making possible for Brazilian and Argentine traders to make business without having to recur to other currencies rather than their local one. It is a payment system that allows the importer to set a payment order that will be send in the exporter's currency but will be paid buy her in her own currency (importer's). One could say that there is an endogenous exchange operation in that payment order.

As one may use different currencies, two major issues arise from the international trade business. First, as already mentioned, there are costs of exchanging currencies and these costs are added to the good's price in the domestic market. As *reais* and *pesos* are not convertible in the international market, a third currency is needed to settle the trade operation, and so additional charges are applicable. As the financial cost of trading raises, less trade is expected to hap-

[2]In fact, as production becomes more integrated due to the globalization process, distinguishing domestic and international processes seems to be justified just for instructional objectives, as a simplified framework.

[3]The currency used for invoicing and for settlement may differ. Friberg and Wilander [9] argue that they are usually the same. In this paper we will assume that the invoicing and settlement currency are the same.

[4]Flandreau and Jobst [10] argue the existence of net externalities on choosing the invoice currency.

[5]By local currency we mean the currency used domestically as legal tender in one's country.

[6]Clearly, the dollar is the most used currency on that role.

pen due to the competitiveness reduction of exported goods. Second, as the moments of setting the price and of the effective payment may differ - and they usually do - exchange rates may varies due to the time gap. Due to this exchange rate variation, the effective traded good's price also floats in reference to a currency. This expected variation is the foreign exchange risk or the currency risk. As the exporter has to match her cost in a certain currency[7], the currency in which the revenues are denominated matters as the foreign exchange risk applies.

3 The SML rationale and comments on trade perspectives

On this section, we will discuss which arguments could support SML existence and how trade may benefit from this payment system. Furthermore, we will consider which grounds are implicit to the SML and how do they differ from the usual trade policies which are taken by these countries.

Hereupon, it seems to be quite clear that the rationale of operating such system comes from the lack of a Brazilian *reais* - Argentine *pesos* foreign exchange market. As the private market does not provide liquidity between these currencies, agents must choose alternatives to financially settle their trade in goods rather than a straightforward forex transaction. We consider that these options bring inefficiency to trade in some extent, as costs of dealing with these failures reduce gains from trade or, at least, reallocate them from trade agents to the financial market. Reducing gains to trade agents implies reducing their propensity to trade, and so these failures may be seen as barriers to trade. As we consider free trade positively correlated to welfare gains, reducing financial costs of trade may be justified.

Public intervention

A prominent theme that emerges from the analysis of SML is that the provision of this financial service is a public intervention. The private market already provides alternative for the settlement of trade operations between the two countries and for international trade, we usually believe that the less the government, the better: lower tariffs and less non-tariff barriers are often associated to less government and higher gains of trade. Nevertheless, the SML is a framework which presents less bureaucratic procedures and makes funds are directly available for the exporter in her own bank account. Additionally, it allows exporters to choose how to do the financial transaction associated the main trade operation, giving them an extra possible option on local currency. So, it seems that more efficiency is provided to the trade business. Undoubtedly, one can state that the SML has succeeded when it is no longer needed. If the system's purpose is to

[7]Without any loss of generality, we assume for simplicity that the exporter's costs are denominated in only one currency. Her costs may be set in a basket of currencies and their weight will define the overall effect.

stimulate a local currency market that allows bilateral trade, by the time this market is set and privately provided, the public intervention will no longer be necessary.

Tendency for SML use

The system was made available by the central banks, however its use is voluntary – as one would expect[8]. So, it agents will rationally choose to use the system as they benefit from it. It is possible to highlight some conditions that may increase the probability on using the payment system. The SML eliminates the forex risk for the exporter in her own currency, so exporters with liabilities primarily on their local currency seem to be more likely to use the payment system. Not every trade transactions between Brazil and Argentina are suitable for SML use. Local currency invoicing will only make sense when the exporter's liabilities suggests that real invoicing - or peso invoicing – reduces currency risk.

In addition to this, companies having subsidiaries in both countries seem to be more likely to use the system since they will face reduced financial transaction costs and they tend to have some easiness to switch hedging from one local currency to the other. As they might locally have a substantial amount of business, they benefit from having a more financially integrated environment.

Another issue that should be taken into account is the exporter's will to receive in her own local currency. In some extent, we could say that the dollar was used as unit of account in Argentina. We may notice that the peso's currency board system remained until the beginning of the last decade when a serious crisis erupted. The resulting severe economic problems lasted for a couple o f years. Therefore, it is expected that, during the years when credibility on the local currency was low, the use of the dollar as reference persisted. As a consequence of that currency perception, it is arguable that the willingness to use *pesos* than dollars by locals is lower, and so the likeliness to receive payment for trade operations in *pesos* through the SML.

Infant regionalization on financial services

The SML connects the national payment systems of both countries. The payment order made available by the SML starts in the payment system of one country and is paid in the payment system of the other country. For example, a payment order sent from an Argentinean importer is instructed in the Argentina's payment system by the local financial institution. After the Central Bank of Argentina receives the payment order, it is followed to the Central Bank of Brazil which instructs the Brazilian financial institution to credit the exporter's bank account within the Brazilian payment system.

Linking the two national payment systems is one step towards a closer relationship for the regional market. A comparison may be made to the former

[8] Some countries in Latin America could still have a political tendency to make this kind of intervention as a mandatory use to agents. Fortunately, this is not the case in Brazil nor in Argentina.

European Union Trans-European Automated Real-time Gross Settlement Express Transfer System (TARGET) that ran until 2007. TARGET used to work as the link of the 15 Eurosystem countries' national payment systems and made euro payment orders available among them. TARGET was replaced by its successor TARGET 2, that is currently in operation. While the latter is a unified supranational payment system provided by the European Central Bank, the former used to be the connection of independent national payment systems, as with the SML[2, 8]. Differently from TARGET, which used to have all its payment orders denominated in the common currency (euro), the SML has to deal with different national currencies, so the endogenous exchange transaction mentioned on the previous section fulfills this additional local trait.

Albeit being unclear the existence of a policy in this sense, the provision of the SML payment order is a step towards regional integration on financial services. This enlarges the Mercosul scope of having most of its actions focused on trade in goods and shows progress towards a financial regional integration.

Taxation and endogenous exchange

In Brazil, taxation differs between SML transactions and regular forex transactions. Trade settled according to regular forex transactions are subjected to the IOF tax[9] on foreign exchange transactions, which is currently an ad-valorem 0.38% rate. The SML payment order, however, does not imply on a direct forex operation.

The exchange operation in the payment system is endogenous. The SML payment order is designed as the importer pays her financial institution in her local currency and the financial institution settles the operation with its national central bank in its own local currency too. The same happens on the exporter's country where all money transfers are on local currency. The exchange operation from one currency to another happens in the SML framework or, more specifically, between both central banks. As no forex happens between agents – traders and financial institutions nor financial institutions and central bank – no tax is due. Thus, on SML operations, trade is waived from 0.38% the IOF tax rate. In practice then we could state that international trade faces lower domestic tariff barriers when happening in the SML framework.

Efforts directing

Why to put effort in making a regional payment system to stimulate trade rather than reducing bilateral tariffs within the customs union? Mercosul is known to be full of exceptions on its common tariffs, so one could expect that consolidating the customs union would be more fruitful. Notwithstanding, the negotiation process of reducing barriers is not simple and involves interests of numerous lobbying groups. Therefore, facing challenges from other perspectives might produce some progress and gains that would hardly be achieved otherwise.

[9]Financial Transaction Tax, on the Portuguese acronym.

While dealing with the exchange rate risk, trade is facilitated in a way diverse from that is typical ones. In some extent, novel alternatives like the SML could be viable tracks to enhance international trade. This could be useful as multilateral negotiations seem to be completely dead-locked in the Doha round and discussions over tariffs and other kinds of barriers face some obstacles on the traditional trade debate.

Sovereign debt concerns

The SML framework also shows how external account liquidity concerns have changed in Latin America since dealing with numerous sovereign defaults in the 1980's. While in that time an agreement which could allow trade operations between countries with a considerable reduced availability of foreign reserves was a major aim (Aladi's CCR), the recent SML agreement is developed over the confidence that countries are able to settle their external trade operations on a daily basis.

4 SML data description

In this section we present some available data for SML[7]. They are summarized on a quarterly basis and compared to the trade data between Argentina and Brazil[5]. About this comparison we shall notice that SML data are related to the financial flow that settles trade operations while the trade data refers to the goods actually shipped during a period. As we quarterly aggregate data from the original monthly basis, we expect that the difference due to the time lag between shipment and payment is smoothed[10], and so data become comparable.

On Table 1, the first three columns (Argentina-to-Brazil payment instructions) refer to the SML transactions placed in Argentina, which are destined to Brazil. It represents the payment for the Brazil-Argentina trade flow: Brazilian exports. The last three columns (Brazil-to-Argentina payment instructions) refer to the opposite financial flow: from Brazil to Argentina, which refers to Argentina exports. Columns [#AB] and [#BA] show the number of transactions originated placed in the SML during the mentioned quarter. The former referred to Brazilian exports and the latter referred to Argentina exports. Columns [amAB] and [amBA] show the total amount in millions of BRL that has been transacted in the SML for the period. We might notice that the original data is denominated in BRL and divided in Brazilian exports and imports as in the data source. Also, we should notice that the Argentina-to-Brazil transactions are originally placed - as invoiced - in BRL, as the SML requires the transaction to be invoice and placed in the remittee's (exporter's) currency. The Brazil-to-Argentina transactions are placed in the SML in ARS and the displayed amount is the sum of the daily original amount converted to BRL according to the SML rate due that date.

[10] Ordinary trade operations are usually expected to be settled in less than 90 days.

Table 1: Total of SML payments per quarter

year	quater	Argentina-to-Brazil payment instructions			Brazil-to-Argentina payment instructions		
		Number of operations [#AB]	Total amount (M BRL) [amAB]	Percentage of trade flow [%AB]	Number of operations [#BA]	Total amount (M BRL) [amBA]	Percentage of trade flow [%BA]
2008	4	33	9.9	0.1	10	1.3	0.02
2009	1	97	20.2	0.5	14	0.7	0.02
	2	211	102.3	1.7	18	0.6	0.01
	3	371	232.8	1.7	21	1.1	0.02
	4	514	198.1	2.2	20	1.9	0.03
2010	1	652	242.5	3.7	8	0.5	0.01
	2	695	212.3	4.2	11	3.7	0.06
	3	914	302.0	3.2	10	0.9	0.01
	4	1149	406.3	4.3	12	3.9	0.06
2011	1	1032	375.5	4.8	10	1.3	0.02
	2	1261	418.6	4.7	6	2.1	0.03
	3	1359	442.6	4.1	11	1.1	0.02
	4	1321	424.2	4.1	23	4.3	0.05
2012	1	1308	426.0	4.6	25	5.0	0.07
	2	1475	492.1	5.7	28	5.4	0.07

[#AB] - number of operations placed in Argentina destined to Brazil;
[amAB] - total amount of operations destination to Brazil in millions of BRL;
[%AB] - percentage of SML transactions to total Brazilian exports to Argentina;
[#BA] - number of operations destined to Argentina;
[amBA] - total amount of operations destined to Argentina in millions of BRL;
[%BA] - percentage of SML transactions to total Brazilian imports to Argentina.

Sources: BCB [7], MDIC[5].

These data show that, from its release, SML usage has been growing and reached approximately 1,500 payment orders on a quarter on the last period available. Brazilian exports through SML [amAB] have shapely risen until keeping a level of BRL 450.0M on about 1,350 operations on the average of the last 12 months. It represents about 3% of the bilateral trade flow. On the other flow direction, the level is considerably lower: it represents 2% of the number of transactions and 0.5% of the total value of transactions, maintaining a level of approximately BRL 5M. Some characteristics may be noticed.

The Brazil-to-Argentina export flow is considerably greater than the flow on the reverse direction. This could endorse the perception that receiving payment in one of the local currency may be more attractive than in the other. The willingness to Argentine exporters receive in *pesos* than in dollar can be smaller than to Brazilian exporters to receive in *reais*. We should observe, however, that stating that Brazilians uses SML the most is misleading. What happens is that the flow in one direction is higher than in the other: as every transaction involves nationals from both countries, both countries use the payment system in the same proportion by definition.

As the flow maintains a level for the latter quarters, one may inquire that may have a level at which is optimal to use the local currency. We may invoke the arguments used to discuss the tendency to use the SML. As not every bilateral trade operation is likely for SML use, it might exist a set of transactions that fits this use. As the pattern of trade persists on time, the ration between this set of operations and the total trade is established. Thus, it is arguable to exist a percentage of trade to which using the SML - or invoicing Brazilian exports in *reais* and Argentine exports in *pesos* - would be appropriated. Characteristics of bilateral trade may lead to quantify this level and estimate its exhaustion therefore. This remains open to further analysis.

We also notice from the data that SML is being used in 4-5% of Argentina-Brazil trade. At a first glance, this could not be seen as relevant in the bilateral trade. Considering that all trade would be directed to SML seems to mislead to this conclusion. As previously argued, the SML brings benefits to trade in certain conditions: in sum, the benefits comes when the exporter to receive in her local currency makes sense. However, this is true only for a percentage of the bilateral trade. Thus, the eventual optimal level for SML use would be the appropriated number to be used as the benchmark.

5 Final comments

Costs and benefits of running an international currency have been studied in trade as a matter of measuring the advantages of having the "exorbitant privilege" of purchasing imports in its own currency. What we have done in this paper was to analyze the implications of a binational payment system which endogenously provides currency exchange on bilateral trade. The reduction of trade costs between Argentina and Brazil due to the SML framework can definitely be stated to those goods for which their cost structure is prime local-currency-based.

The SML addresses an issue that is a barrier to trade in the sense of being a barrier to traders to make business. We tried to analyze international trade not only from a state-level point of view. If benefits from international trade are a quite clear issue, making business to happen in an easier way with lower costs will certainly make these benefits available.

Albeit being a very limited experience between the two countries, SML can be noticed as an innovative tool developed to reduce forex costs between two major trading partners. The SML framework shows that a regional agreement may address an issue that is not dealt in WTO multilateral negotiations. This is specially interesting to be noticed when the Doha round seems to be dead-locked for some more years making the trade agenda also locked.

We described and analyzed some consequences of the SML framework on reducing trade costs between Argentina and Brazil. The effectiveness of this novel framework remains as an open field of study. Nonetheless, it is clear that non convertibility of Mercosul's local currencies drains gains from regional trade and the government's provision of liquidity to an incipient forex market is an attempt to address this financial distortion to trade.

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